

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:LM:RFP:CHI:2:POSTF-147851-01
MJCalabrese

date:

to: Debra Johnson, Team Coordinator

from: Associate Area Counsel (LMSB), Chicago

subject: **Opinion - Operating Agreement Amortization Expense and Bad Debt
Loss Deduction**

Taxpayer: [REDACTED]

This responds to your requests for assistance dated August 24, 2001 and September 26, 2001. It does not appear that there is an issue in this case that requires coordination with an industry counsel. This memorandum should not be cited as precedent.

ISSUES

1. Whether the taxpayer may take a deduction for the remaining value of an operating agreement, where the agreement covered an additional 8 month period at the time it was cancelled.

2. Whether the facts and circumstances show that the taxpayer was owed a \$[REDACTED] plus interest indebtedness by a partnership, where an affiliate of the taxpayer was the general partner of the partnership.

CONCLUSIONS

1. The taxpayer may not take a deduction for the remaining value of an operating agreement.

2. The facts and circumstances do not show a bona fide indebtedness existed.

FACTS

1. Operating Agreement Amortization Expense

[REDACTED] held a concession contract from

the [REDACTED] for [REDACTED] On [REDACTED] [REDACTED] and [REDACTED] entered into an operating agreement. The agreement expired [REDACTED]. In [REDACTED] [REDACTED] owned [REDACTED] of [REDACTED].

Pursuant to the operating agreement, [REDACTED] undertook responsibility to manage, operate, and promote the [REDACTED] concession for [REDACTED]. [REDACTED] received and reported as income management fees from [REDACTED].

[REDACTED] owed [REDACTED] \$[REDACTED] in the form of notes payable. Apparently the notes were secured by real estate contributed to [REDACTED] as capital. The obligation created an interest expense deduction that flowed through to [REDACTED]. [REDACTED] had corresponding interest income.

[REDACTED] and [REDACTED] terminated the operating agreement in [REDACTED]. Both parties treated this event as if money had changed hands. [REDACTED] reported this as a sale to [REDACTED] with a \$[REDACTED] gain. [REDACTED] treated the event as [REDACTED] paying down its obligation to [REDACTED] by \$[REDACTED]. [REDACTED] credited notes receivable, but, instead of debiting an asset (other investment), [REDACTED] debited amortization expense for the remaining value of the operating agreement. [REDACTED] contributed to the capital of [REDACTED] the remaining amount of the [REDACTED]'s obligation to it.

The parties, and not an outside party, determined a \$[REDACTED] remaining value for the operating agreement. [REDACTED] did not sell the agreement to another party.

2. Bad Debt

[REDACTED], an S corporation, was a general partner of and owned [REDACTED] of the [REDACTED], an Illinois limited partnership. Interests in this partnership traded publicly. Approximately [REDACTED] limited partners owned the other [REDACTED] of [REDACTED].

Since [REDACTED], the directors and executive officers of [REDACTED] also served as directors and executive officers of [REDACTED]. These individuals also owned shares in [REDACTED].

[REDACTED] was a partner in [REDACTED] an Illinois general partnership. We are uncertain as to who were partners in [REDACTED] and when they served as partners (as discussed hereafter in the Analysis).

On [REDACTED] [REDACTED] purportedly received

value from and gave a note to [REDACTED], a Delaware Corporation (sometimes hereinafter referred to as [REDACTED]). The note was for \$ [REDACTED] due and payable (with various exceptions) on [REDACTED]. The transaction presumably related to [REDACTED]'s interest in [REDACTED]. [REDACTED] had its principal office and place of business at [REDACTED].

The [REDACTED] note provided for payment of prepaid interest of \$ [REDACTED] for the months of [REDACTED], [REDACTED] and [REDACTED] and a [REDACTED] interest payment of \$ [REDACTED] for the month of [REDACTED]. In [REDACTED] [REDACTED] made these interest payments totaling \$ [REDACTED]. The note contained a number of rules regarding accrual and payment of interest after [REDACTED] including a provision that interest was to be paid from "Available Cash", a technically defined term that, under certain conditions and with various exceptions, limitations, and qualifications, consisted of net cash receipts exceeding \$ [REDACTED]. All accrued and unpaid interest was due and payable [REDACTED].

A provision on page 5 of the note stated that the note "inures to the benefit of [REDACTED] and its successors and assigns". This provision also states that where the note refers to "[REDACTED]" it includes and means the successors and assigns of [REDACTED].

With certain qualifications, the note states that [REDACTED] and its partners are not personally liable on the note. Liability is limited to [REDACTED]'s interest in the [REDACTED] partnership.

The note was executed by [REDACTED], an Illinois corporation, as a general partner of and on behalf of [REDACTED]. [REDACTED], through a senior vice president, signed an allonge to the note that said "[p]ay to the order of the [REDACTED] without recourse or warranty."

[REDACTED] and [REDACTED] also executed on [REDACTED], a Security Assignment of Partnership Interest (Security Assignment). [REDACTED] granted a security interest in and assigned to [REDACTED] the interest of [REDACTED] in the [REDACTED] partnership.

The Security Assignment states that [REDACTED] gave the \$ [REDACTED] note pursuant to an agreement among [REDACTED], [REDACTED], and [REDACTED], a Delaware

corporation.

In [REDACTED] an Illinois general partnership ([REDACTED]) acquired the assets of [REDACTED] in what the taxpayer described as a \$ 338 transaction. The taxpayer claims that prior to the \$ 338 transaction, [REDACTED] was the real estate development subsidiary of [REDACTED], and unrelated to the taxpayer. [REDACTED], on the other hand, was [REDACTED] owned by the taxpayer's affiliate [REDACTED].

In a Purchase Agreement dated [REDACTED] [REDACTED] purportedly sold the [REDACTED] note to [REDACTED]¹, an Illinois corporation. In exchange for the [REDACTED] \$ [REDACTED] note, [REDACTED] gave [REDACTED] a demand note for \$ [REDACTED]. This amount consisted of \$ [REDACTED] for principal and \$ [REDACTED] for interest. The taxpayer did not have documentation verifying [REDACTED] reporting the \$ [REDACTED] as income.

The [REDACTED] Purchase Agreement was executed by the president of [REDACTED] on behalf of the seller [REDACTED]. The signature line states that [REDACTED] is the managing partner of [REDACTED].

In a Collateral Assignment dated [REDACTED] [REDACTED] granted, assigned, pledged, and transferred to [REDACTED] and certain other banks (the Banks) all of its right, title, and interest in "the [REDACTED] Note and the Pledge and Security Agreement referred to therein securing payment of the [REDACTED] Note" It appears that the person who executed the Collateral Assignment on behalf of [REDACTED] also executed a consent and agreement to the Collateral Assignment on behalf of [REDACTED]. This same person signed the allonge to the [REDACTED] note.

The recitals to the Collateral Assignment include a statement that [REDACTED] and the Banks entered into a Credit Agreement. The recitals also include a statement that the Banks are willing to consent to [REDACTED]'s transfer to [REDACTED] the [REDACTED] note under certain terms set forth in an amendment to the credit agreement. These terms include the requirement that the [REDACTED] note be pledged to the Banks.

¹ At the time [REDACTED] was known as [REDACTED]. For convenience we will refer to it as [REDACTED].

accrued unpaid interest on the note for each of the years through . The total accrued unpaid interest through amounted to \$. After , no longer accrued unpaid interest, purportedly because it concluded that was unlikely to pay.

On merged into . For taxable year took a \$ partial bad debt deduction. had determined that it could not collect the full amount of its \$ tax basis in the note.

The taxpayer stated that on entered into a Settlement and Proceeds Sharing Agreement in which it agreed to pay \$. This amount exceeded s remaining basis in the note by \$. says that it included this gain in its taxable income for . also says that reported debt forgiveness income of \$.

ANALYSIS

1. Operating Agreement Amortization Expense

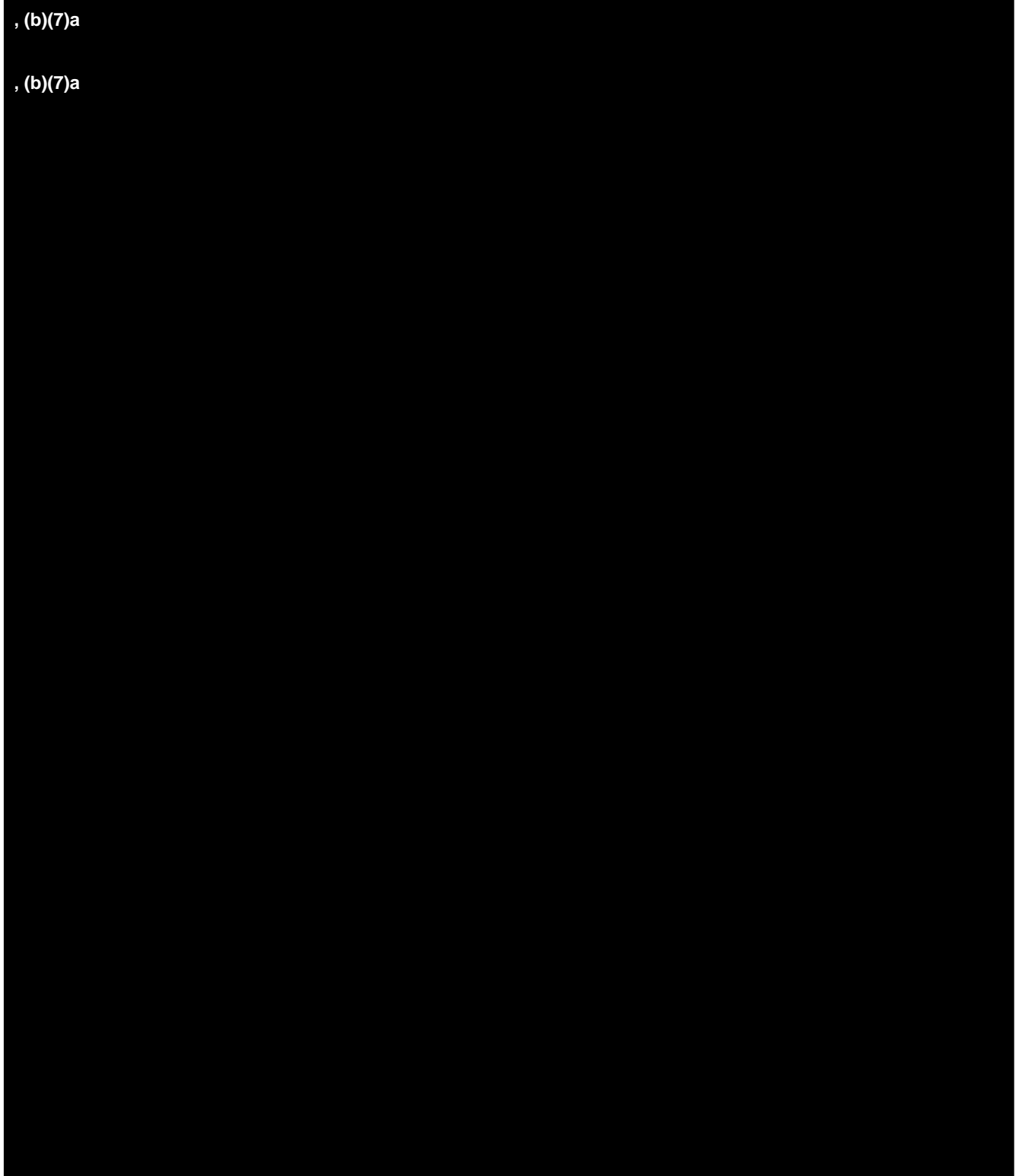
held a concession agreement for . In an operating agreement with , contracted to operate, manage, and promote the concession.

In its submissions, the taxpayer states that the operating agreement provided with the right to the "net cash flow from the facilities". This right to the net cash flow constituted a fee paid by to for managing the concession. Presumably received some benefit from the operating agreement, though the information we have seen does not indicate the nature of the benefit.

The parties cancelled the operating agreement on or about . The agreement had 8 more months before it was scheduled to expire. The known facts do not indicate the reason for the cancellation of the agreement. claimed a \$ gain on the cancellation and claimed a \$ deduction.

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² [REDACTED] may or may not have been entitled to compensation for cancellation of the agreement, depending upon the reasons for the cancellation and the terms of the agreement.

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2. Bad debt

a. Legal principles and factual circumstances determine whether a bona fide debt existed

The Form 886-A, Explanation of Items, properly and appropriately notes that a bona fide bad debt must arise "from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." Treas. Reg. § 1.166-1(c). To the extent the bad debt is based upon an accrual taxpayer's receivables, the amount of the receivables must have been included in the taxpayer's income. Id.

Determining the existence of a bona fide indebtedness depends upon the particular facts of the case. In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. Various courts have considered different tests and relevant factors; however, "in the final analysis . . . the question depends on the facts and circumstances of each case". Kean v. Commissioner, 91 T.C. 575 (1988). The question of genuine debt does not turn on any one factor, and not all factors may apply in a particular case. Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980).

Contributions to the equity of a business do not create a debt for purposes of I.R.C. § 166. Kean v. Commissioner, 91 T.C. 575 (1988); Treas. Reg. § 1.166-1(c). Whether a transfer of funds to a business constitutes debt or equity is a question of both fact and law. In the Matter of Larson, 862 F.2d 112 (7th Cir. 1988). Advances from a parent to a subsidiary are subject to close scrutiny as control allows an opportunity for the parent to create a fictional debt. Roth Steel Tube Co. v. Commissioner,

800 F.2d 626 (6th Cir. 1986); In the Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976).

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Notes are negotiable. The Uniform Commercial Code provides generally that the transfer of a negotiable instrument is accomplished by delivery and any necessary indorsement. Indorsement is required when the note is payable to the order of an identified person (as opposed to being payable to bearer). See 810 ILCS 5/3-201(a) and (b); 6 Del. Code 3-201(a) and (b); Wis. Stat. § 403.202(1).

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b. The taxpayer has not established any basis in the note

In this case, the taxpayer says that [REDACTED] was an unrelated corporation, but that in [REDACTED] an entity related to the taxpayer, [REDACTED] acquired the assets of [REDACTED] in a § 338 transaction. (b)(7)a

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A taxpayer may deduct a business bad debt to the extent of its adjusted basis in the debt. Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276; I.R.C. § 166(b). (b)(7)a

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c. The facts and circumstances do not show that a bona fide indebtedness existed

The Form 886-A goes through a number of important factors in determining the existence of a bona fide bad debt. (b)(7)a

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d. Treas. Reg. § 1.1502-15T

In noting that the taxpayer requested to retroactively elect Treas. Reg. § 1.1502-15T, you indicate that the taxpayer will be providing some additional valuation information. (b)(7)a

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e. Reversal of [REDACTED]'s interest income accrual

The taxpayer contends that between [REDACTED] and [REDACTED] [REDACTED] reported for tax purposes accrued interest income relating to the [REDACTED] note. No interest accrued or was reported as income after [REDACTED]. The taxpayer suggests that if it is determined that a bona fide indebtedness did not exist, then [REDACTED] [REDACTED] should be allowed to back out the interest income it reported.³

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f. Case development

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This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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If you have any questions on this matter please call Michael Calabrese of this office at (414) 297-4241.

Associate Area Counsel (LMSB),
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By: _____
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